



## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-89464; File No. SR-NASDAQ-2020-017]

### Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of a Proposed Rule Change to Amend Nasdaq Rule 5704

August 4, 2020

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup>, and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 23, 2020, The Nasdaq Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I and II, below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend Nasdaq Rule 5704 to remove the listing requirement that following twelve months after listing a series of Exchange Traded Fund Shares (the “Fund”) on Nasdaq that the Fund has at least 50 beneficial holders and to amend the requirement that Nasdaq will establish a minimum number of shares of the Fund to be outstanding at the time of initial listing with a requirement that the Fund must have a minimum number of shares outstanding to facilitate the formation of at least one creation unit on an initial and continued listing basis.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

The text of the proposed rule change is available on the Exchange's Website at <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend Nasdaq Rule 5704 to remove the listing requirement that following twelve months after listing a series of an Exchange Traded Fund Shares on Nasdaq that the Fund has at least 50 beneficial holders and to amend the requirement that Nasdaq will establish a minimum number of shares of the Fund to be outstanding at the time of initial listing with a requirement that the Fund must have a minimum number of shares outstanding to facilitate the formation of at least one creation unit on an initial and continued listing basis.<sup>3</sup>

Nasdaq believes that the requirement that a series of Exchange Traded Fund Shares listed pursuant to Nasdaq Rule 5704 must have at least 50 beneficial shareholders is no longer

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<sup>3</sup> The term creation unit would have the same meaning as defined in Rule 6c-11 (i.e., a specified number of exchange-traded fund shares that the exchange-traded fund will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount, if any.).

necessary. The Exchange believes that the conditions of Rule 6c-11<sup>4</sup> (“Rule 6c-11”) under the Investment Company Act of 1940, as amended,<sup>5</sup> coupled with the existing creation and redemption process, mitigate the potential lack of liquidity that the shareholder requirement was intended to address.<sup>6</sup> Nasdaq believes that requiring a sufficient number of shares to be outstanding at all times in order to facilitate the formation of at least one creation unit, coupled with the daily portfolio transparency and other enhanced disclosure requirements of Rule 6c-11, will facilitate an effective arbitrage mechanism and provide market participants and investors with sufficient transparency into the holdings of the underlying portfolio and ensure that the trading price in the secondary market remains in line with the value per share of the portfolio. The Exchange believes this is consistent with prior Commission statements.<sup>7</sup>

For example, Rule 6c-11 requires additional disclosure if the premium or discount is in excess of 2% for more than seven consecutive days, as well as related website disclosure and

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<sup>4</sup> A series of Exchange Traded Fund Shares listed pursuant to Nasdaq Rule 5704 is required to be eligible to operate pursuant to Rule 6c-11. See Nasdaq Rule 5704(b).

<sup>5</sup> See Release No. 33-10695; IC-33646; File No. S7-15-18 (Exchange-Traded Funds) (September 25, 2019), 84 FR 57162 (October 24, 2019) (“ETF Adopting Release”).

<sup>6</sup> As stated in previous rule proposals, Nasdaq believes that the shareholder requirement, as it relates to common stock, is a measure of liquidity designed to help assure that there will be sufficient investor interest and trading to support price discovery once a security is listed. See Securities Exchange Act Release No. 86314 (July 5, 2019), 84 FR 33102 (July 11, 2019) (Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 3, To Revise the Exchange’s Initial Listing Standards Related to Liquidity). However, as discussed herein, the pricing, liquidity, trading and valuation of Exchange Traded Fund Shares is fundamentally different from that of common stock.

<sup>7</sup> In the Adopting Release, the Commission stated, “Further, we believe that the conditions we are adopting as part of rule 6c-11, along with other recent actions that are designed to promote an effective arbitrage mechanism, will continue to result in a sufficiently close alignment between an ETF’s market price and NAV per share in most circumstances...” See supra note 6, at pp. 41.

discussion requirements.<sup>8</sup> This disclosure provides additional transparency to investors in the event that the trading value and the underlying portfolio deviate for an extended period of time, which could indicate an inefficient arbitrage mechanism.<sup>9</sup> The arbitrage mechanism relies on the fact that shares of the Fund can be created and redeemed and that shares of the Fund are able to flow into or out of the market when the price of the Fund is not aligned with the net asset value per share of the portfolio. The resulting buying and selling of the shares of the Fund, as well as the underlying portfolio components, generally causes the market price and the net asset value per share to converge. The Exchange believes this is consistent with prior Commission statements.<sup>10</sup>

In addition, the proper functioning of the arbitrage mechanism is reliant on the presence of authorized participants (“APs”) that are eligible to facilitate creations and redemptions with the fund and support the liquidity of the fund. The AP facilitates liquidity in the ETF primary market by purchasing shares of the underlying portfolio and transferring the shares to the ETF issuer in exchange for shares of the ETF (creation) or returning shares of the ETF to the issuer and receiving shares of the portfolio (redemption). Therefore, the ability of the AP to transact in shares of the ETF plays a vital role in the liquidity of the ETF and the functioning of the arbitrage mechanism. The AP is able to buy and sell shares of the ETF from both the fund and investors. Because ETFs can be created and redeemed “in-kind” and do not have an upper limit

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<sup>8</sup> See 17 CFR 270.6c-11(c)(1)(vi).

<sup>9</sup> The Exchange notes that the Commission discussed the importance of an effective and efficient arbitrage mechanism in the Rule 6c-11 Release. See *supra* note 6 at pp. 14-16.

<sup>10</sup> In the ETF Adopting Release, the Commission stated, “The combination of the creation and redemption process with secondary market trading in ETF shares and underlying securities provides arbitrage opportunities that are designed to help keep the market price of ETF shares at or close to the NAV per share of the ETF.” See ETF Adopting Release at pp. 12-13.

of the number of shares that can be outstanding, an AP can fulfill customer orders or take advantage of arbitrage opportunities regardless of the number of ETF shares currently outstanding. Thus, unlike common stock, the liquidity of an ETF is not dependent on the number of ETF shares currently outstanding or the number of shareholders, but on the availability of AP's to transact in the ETF primary market. The Exchange notes that the SEC did not adopt a minimum number of APs as part of Rule 6c-11 because funds already have enough APs so that a need for such a requirement to ensure a sufficient number of APs was unwarranted.<sup>11</sup>

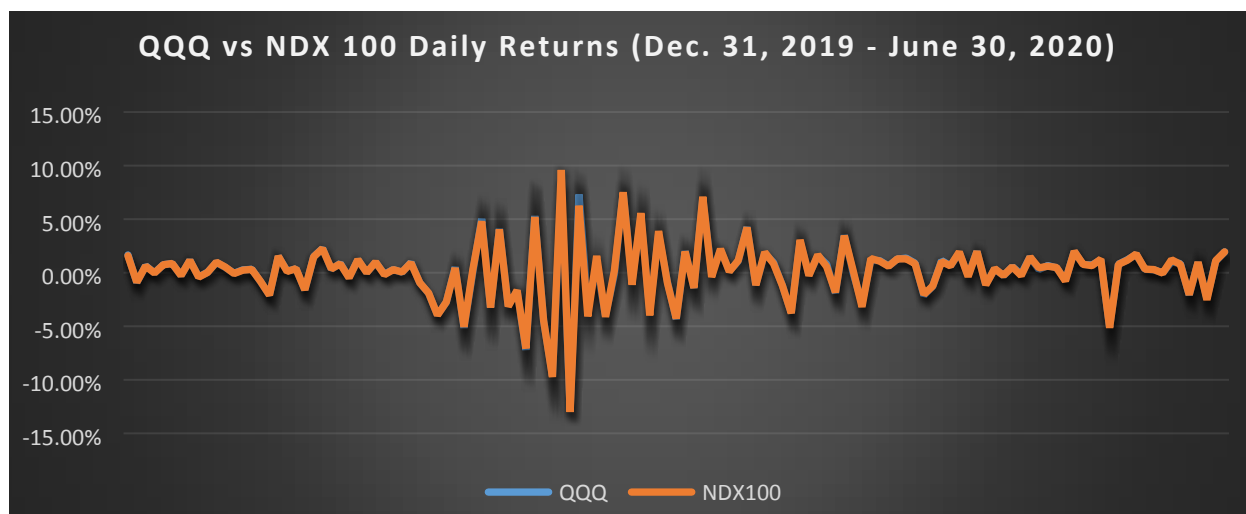
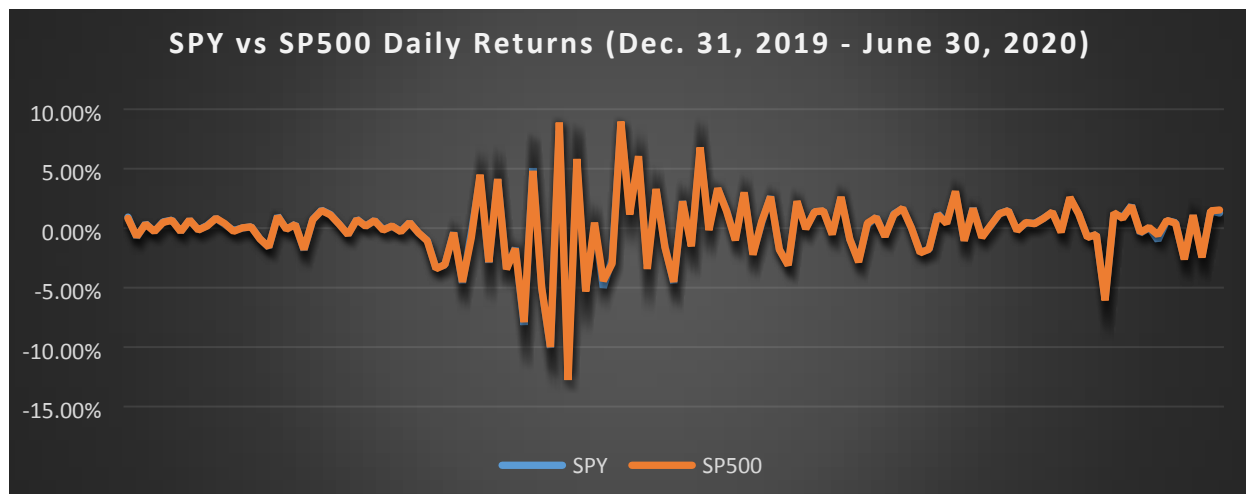
ETF liquidity, due to its open-ended structure allowing for creations and redemptions, differs from single company stocks because the opportunity for market makers to arbitrage between the ETF price and the value of the underlying securities exists. Even during market conditions marked by large buying or selling imbalances in the ETF, the ETF should be expected to trade close to the value of its underlying holdings provided that the creation/redemption facility remains open and accessible. To demonstrate, the two charts below<sup>12</sup> compare the percentage daily returns of both SPY and QQQ compared to their respective benchmark indices the S&P 500 and the Nasdaq 100. SPY and QQQ, as passive ETFs, are managed to track the returns of the benchmark index by replicating the holdings of the index. As can be seen in the two charts below, the returns of both SPY and QQQ are kept close in line through the availability of the arbitrage mechanism. It is important to note that this dynamic of close tracking was able to

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<sup>11</sup> “Additionally, based upon Form N-CEN data through September 5, 2019, we found that out of 1672 funds reviewed that could rely on rule 6c-11, only 30 (approximately 1.8% of the funds reviewed) reported having fewer than 2 APs. We therefore do not believe that it is appropriate at this time to prescribe a minimum number of APs that an ETF may use.” See ETF Adopting Release at p. 54.

<sup>12</sup> FactSet Research Systems Inc. (2020). SPY vs SP500 Daily Returns (Dec. 31, 2019 – June 30, 2020) and QQQ vs NDX 100 Daily Returns (Dec. 31, 2019 – June 30, 2020). Retrieved July 17, 2020, from FactSet database.

occur during a period of unprecedented volatility and volumes in both ETFs. The observations period was the first two quarters of 2020.

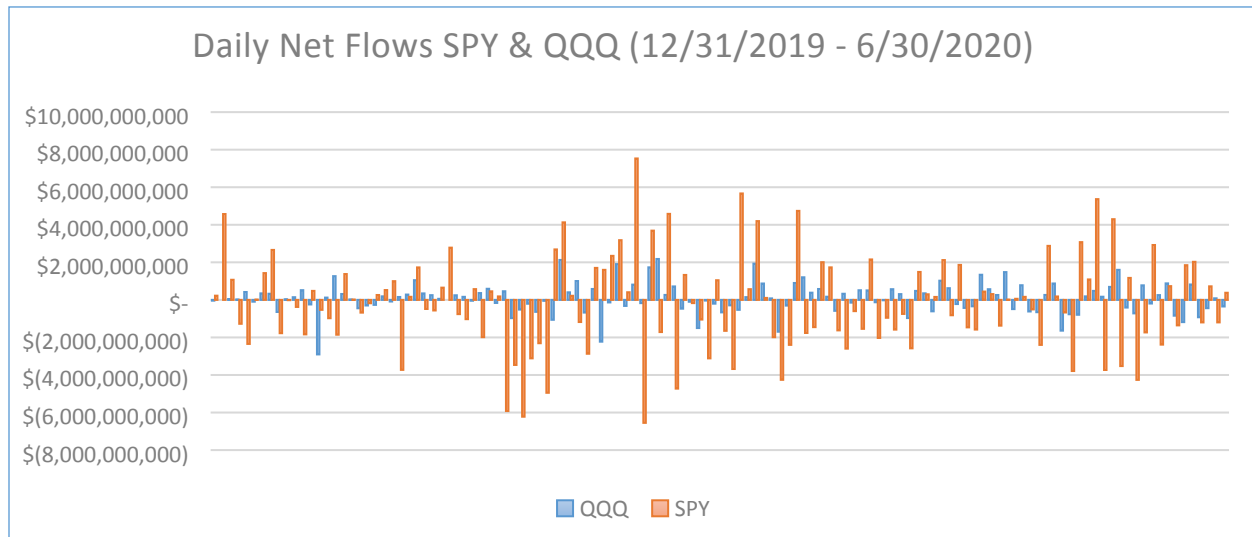


The chart below<sup>13</sup> maps out daily net flows through creation/redemption activity in the same observation period to give evidence that there likely were significant buy/sell imbalances where market makers were able to keep the returns of SPY and QQQ in line with their benchmark indices through the availability of arbitrage in the open-ended ETF structure. This dynamic also works similarly in an ETF with little or no daily trading activity, where a market

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<sup>13</sup> FactSet Research Systems Inc. (2020). Daily Net Flows SPY & QQQ (12/31/19 – 6/30/20). Retrieved July 17, 2020, from FactSet database.

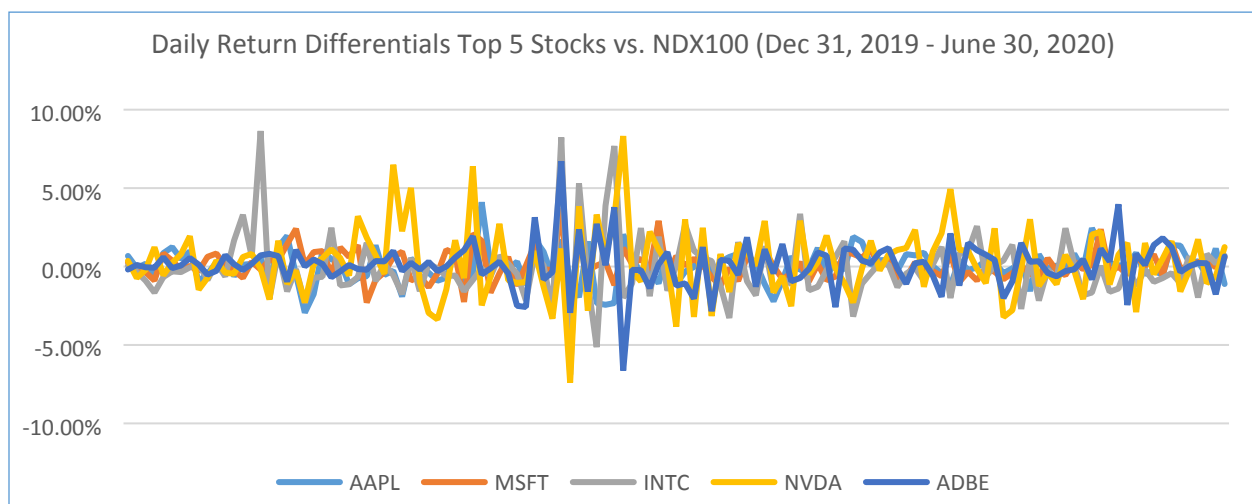
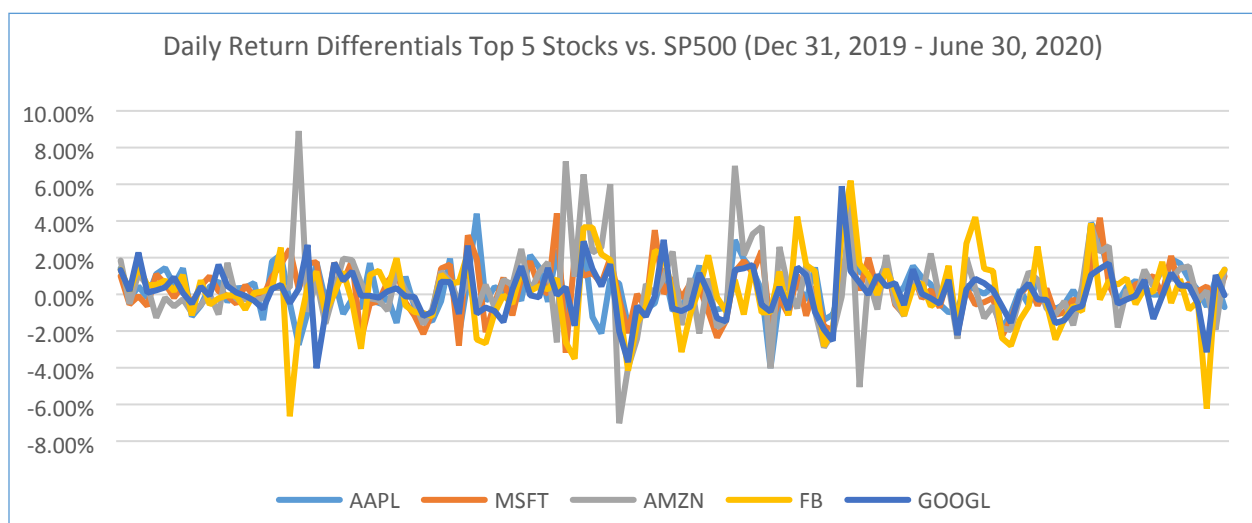
maker can generally be expected to provide liquidity in this ETF that is higher than the average daily volume through creation/redemption. The market maker will consider the availability of the arbitrage mechanism and liquidity of the underlying fund securities significantly more than the awareness that an ETF has 50 or greater shareholders who may or may not even trade on a given trading day.



To further illustrate how the arbitrage mechanism makes ETF liquidity differ from single stock liquidity, the two charts below<sup>14</sup> take the 5 highest weighted stocks from the S&P 500 and Nasdaq 100 indices and compare their daily percentage returns against the daily percentage returns of the index they are constituents of. These stocks are some of the largest and most actively held and traded names on a daily basis, and the point being made is that these stocks are not open-ended and therefore impact how market makers trade them and consider the availability and activity of other trading participants. The observation period remains the first two quarters of

<sup>14</sup> FactSet Research Systems Inc. (2020). Daily Return Differentials Top 5 Stocks vs. SP500 (Dec 31, 2019 – June 30, 2020) and QQQ vs NDX 100 Daily Returns (Dec. 31, 2019 – June 30, 2020) and Daily Return Differentials Top 5 Stocks vs. NDX100 (Dec. 31, 2019 – June 30, 2020). Retrieved July 17, 2020, from FactSet database.

2020. When looking at the relative returns of each of these stocks against the “market” as these indices are commonly referred, we see that there are often significant daily return variations between the stock and the index. The stocks do not have the open-ended structure to create or redeem shares like the ETF; therefore, the market makers in the stocks must consider daily buying and selling imbalance activity to reduce risk on their balance sheets by quickly adjusting their trading prices directly in reaction to large trading imbalances. The expectation of other shareholders buying and selling the stock on a daily basis will impact how market makers adjust their prices significantly more than in an ETF due to their expected ability to quickly and efficiently trade out of risk.





In order for fund redemptions to be executed in support of the arbitrage mechanism, Nasdaq believes it is appropriate that in lieu of the shareholder requirement that the Fund has a sufficient number of shares outstanding in order to facilitate the formation of at least one creation unit on an initial and continued listing basis. The existence of the creation and redemption process, daily portfolio transparency, as well as a sufficient number of shares outstanding to allow for the formation of at least one creation unit, ensures that market participants are able to redeem shares and, thereby support the proper functioning of the arbitrage mechanism. Of the over 350 funds currently listed on Nasdaq that would be eligible to be listed under Nasdaq Rule 5704, only two had a single creation unit outstanding. The remaining funds have, on average, shares outstanding equal to approximately 300 creation units.<sup>15</sup>

Therefore, the symbiotic relationship between the disclosure requirements of Rule 6c-11, the ability of the AP to create and redeem shares of a fund, and the functioning of the arbitrage mechanism helps to ensure that the trading price in the secondary market is at fair value. This renders the need for a shareholder requirement, whose original purpose was to support a fair and orderly trading, as duplicative and unnecessary. Finally, Nasdaq's surveillance program and its ability to halt trading in a fund provides for additional investor protections by further mitigating any abnormal trading that would affect the Fund's price.<sup>16</sup>

## 2. Statutory Basis

The Exchange believes that the proposal is consistent with Section 6(b) of the Act<sup>17</sup> in general and Section 6(b)(5) of the Act<sup>18</sup> in particular in that it is designed to prevent fraudulent

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<sup>15</sup> Nasdaq internal data as of March 31, 2020.

<sup>16</sup> See Nasdaq Rule 4120(a)(10).

<sup>17</sup> 15 U.S.C. 78f.

<sup>18</sup> 15 U.S.C. 78f(b)(5).

and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Exchange believes that the proposed rule change to amend Nasdaq Rule 5704 to remove the 50 beneficial holder requirement and to amend the shares outstanding listing requirement, as discussed above, will promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. As discussed herein, reliance on the conditions of Rule 6c-11, coupled with the existing creation and redemption process, as well as the presence of sufficient shares to support the creation and redemption process, serve to mitigate the potential for a lack of liquidity that the shareholder requirement was intended to address.<sup>19</sup> By further aligning the listing requirements with the operational relationship between investors, market participants and ETF issuers, the proposal facilitates greater transparency for investors and issuers resulting in a more efficient market and increased investor protections.

For the above reasons, the Exchange believes that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purpose of the Act. The Exchange believes that the proposed rule change will maintain the integrity of Nasdaq Rule 5704 on an initial and continued listing basis to the benefit of investors and the marketplace.

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<sup>19</sup> See supra note 6.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve or disapprove such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2020-017 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2020-017. This file number should be included on the subject line if e-mail is used. To help the Commission process and review

your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2020-017, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>20</sup>

**J. Matthew DeLesDernier,**  
*Assistant Secretary.*

[FR Doc. 2020-17303 Filed: 8/6/2020 8:45 am; Publication Date: 8/7/2020]

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<sup>20</sup> 17 CFR 200.30-3(a)(12).